

Internal Revenue Service

memorandum

CC:INTL-0199-90

Br3:KKSchlaman

date: OCT 31 1990

to: Scott Preacher, International Examiner

from: Bernard T. Bress, Senior Technical Reviewer

subject: [REDACTED] --Informal Counsel Assistance (ICA)

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Facts: Pursuant to an agreement dated [REDACTED], [REDACTED], a U.S. corporation, and [REDACTED] individual residents of Canada transferred a license to [REDACTED] on [REDACTED]. In exchange, the shareholders were entitled to receive [REDACTED] shares of [REDACTED] common stock, [REDACTED] Canadian dollars (C\$) and [REDACTED] % of the net sales of [REDACTED] (under a License Agreement dated [REDACTED]).

Revenue Canada may have valued the [REDACTED] shares at C\$ [REDACTED], since it treated the transaction as a purchase by [REDACTED] of a license from [REDACTED] for C\$ [REDACTED] subject to [REDACTED] withholding tax.

For purposes of this memorandum, we have assumed the validity of the agreement dated [REDACTED]. The Examination Division has raised issues related to this Agreement that are not the subject of this memorandum.

In a memorandum dated August 31, 1987, [REDACTED]'s Director of Taxes stated that the [REDACTED] % royalty fee provided in the License Agreement dated [REDACTED], "is treated as equal to the deemed payments required by Section 367(d)." In addition, it was stated that these royalty payments would be treated as U.S. source income.

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Issues:

1. Assuming that the requirements of section 351 are otherwise met, does section 367(d) apply to this transaction?

2. If section 367(d) applies to this transaction, how will the stock, cash and royalty payments received in the section 351 transaction be treated?

Discussion:

Issue 1. Assuming that the requirements of section 351 are otherwise met, does section 367(d) apply to this transaction?

Section 367(a)(1) provides:

If, in connection with any exchange described in section 332, 351, 354, 356, or 361, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation.

██████ is a U.S. person under section 7701(a)(30), which defines a U.S. person to include a domestic corporation. It is assumed for purposes of this memorandum that ██████ and the ██████ individual transferors, which constitute a control group under 368(c), have transferred intangible property, the license, to a foreign corporation, ██████, in connection with a transfer described in section 351.

Section 367(d)(1) provides, in part:

[I]f a United States person transfers any intangible property (within the meaning of section 936(h)(3)(B)) to a foreign corporation in an exchange described in section 351 or section 361--

(a) subsection (a) shall not apply to the transfer of such property, and

(b) the provisions of this subsection shall apply to such transfer.

Section 367(d)(1) applies to the transfer because ██████ is a U.S. person and because the license is intangible property within the meaning of section 936(h)(3)(B), which defines intangible property to include any franchise, license or contract.

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Section 367(d)(2)(A) provides, in part:

If paragraph (1) applies to any transfer, the United States person transferring such property shall be treated as---

(i) having sold such property in exchange for payments which are contingent upon the productivity, use, or disposition of such property, and

(ii) receiving amounts which reasonably reflect the amounts which would have been received--

(I) annually in the form of such payments over the useful life of such property

Thus, assuming that the requirements of section 351 are met, section 367(d) applies to this transaction.

Issue 2. If section 367(d) applies to this transaction, how will the stock, cash and royalty payment received in the section 351 transaction be treated?

If the license had been transferred to [REDACTED] solely for stock of [REDACTED] section 367(d)(2)(A) would have treated [REDACTED] as having transferred the license in exchange for payments that are contingent upon the productivity, use or disposition of the license, and as having received amounts which reasonably reflect the amounts which would have been received annually in the form of such payments over the useful life of such property. See, § 1.367(d)-1T(a). Section 1.367(d)-1T(c)(1) provides:

Such person [the transferor] shall, over the useful life of the property, include in gross income an amount that represents an appropriate arms-length charge for the use of the property. The appropriate charge shall be determined in accordance with provisions of section 482 and the regulations thereunder. See § 1.482-2(d).

Such amounts are treated as ordinary income from sources within the United States. §§ 367(d)(2)(C), 1.367-1T(c)(1).

The literal language of section 367(d), which treats a U.S. person that transfers intangible property to a foreign corporation in a section 351 exchange as if it received a U.S. source royalty, applies whether or not boot is received in the § 351 exchange and does not "carve out" the boot from section 367(d) treatment. Notwithstanding the literal language of section 367(d), we believe that it is appropriate to give effect to the transfer as structured by [REDACTED] to the extent the

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transfer does not violate the purpose of section 367(d), and we believe the tax consequences of so doing would be more favorable to the taxpayer.¹ Thus, [REDACTED] will be treated as receiving its share of the royalty of [REDACTED] percent of net sales, as provided under the license agreement. The share of the royalty will be treated, under sections 865(d)(1) and 862(a)(4), as income from sources outside the United States to the extent the royalty is for the right to use the intangible property outside the United States. [REDACTED]'s share of the CS [REDACTED] will be treated, under section 865(a)(1), as income from sources within the United States.

In addition to recognizing gain on the boot received in the transfer, [REDACTED] will be required to recognize gain under section 367(d) for any year in which the amounts otherwise recognized are less than the amount that would be recognized under the arm's-length standard of section 367(d). Thus, for example, if section 367(d) would require (using section 482 arm's-length principles) that [REDACTED] recognize \$ [REDACTED] in the year of the transfer, and the value of [REDACTED]'s share of the CS [REDACTED] and the [REDACTED] percent royalty was only \$ [REDACTED] for the year, section 367(d) would treat [REDACTED] as receiving an additional U.S. source royalty of \$ [REDACTED].

The analysis is somewhat more complicated where the value of the boot exceeds the arm's-length price required under section 367(d). As a general rule, a taxpayer may not invoke section 482 to change the amount of a transfer price, and it thus seems appropriate to require the shareholders to recognize the full amount of the boot even where it exceeds the arm's-length royalty amount required under section 367(d). See § 1.482-1(b)(3).² However, the new section 482 regulations governing the transfer of intangibles may treat a lump-sum payment for an intangible (the CS [REDACTED] in this case) as if it

¹Cf. Treas. Reg. § 1.367(d)-1T(g)(2), which allows a taxpayer to elect, under certain circumstances, to treat the transfer of an intangible as a sale and to recognize all gain in the year of the sale, rather than to receive royalty payments over the useful life of the property.

²In addition, since the position taken in this memorandum grants [REDACTED] relief from application of section 367(d) to the entire transaction (which would treat all gain as U.S. source), they are not in a strong position to argue against this treatment.

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were a prepayment of amounts that would be determined under an arm's-length royalty arrangement. Thus, any overpayment would be credited against payments due in later years, and the transferee, [REDACTED], might also be given credit for hypothetical interest on the overpayment.

The regulations may also allow overpayments under a royalty arrangement to offset underpayments in later years. Thus, if the [REDACTED] percent royalty amount exceeded the arm's-length royalty rate required by section 367(d), the excess might be used to offset an underpayment in a later year in which the arm's-length royalty amount exceeded the [REDACTED] percent royalty amount.

To apply these rules to the present case, suppose that section 367(d) would require [REDACTED] to recognize a royalty of \$[REDACTED] in the year of the transfer, that [REDACTED]'s share of the CS [REDACTED] is worth \$[REDACTED] at the time of payment, and that [REDACTED]'s share of the [REDACTED] percent royalty for the year is \$[REDACTED]. [REDACTED] would be required to recognize \$[REDACTED] (\$[REDACTED] + \$[REDACTED]) in the year of the transfer, even though application of section 367(d) would only require recognition of \$[REDACTED]. The overpayment of \$[REDACTED] would reduce any amounts due under section 367(d) (i.e., the difference between the arm's-length price and the [REDACTED] percent royalty) in later taxable years. The shareholders might be allowed to treat the overpayment as a loan and to pay and deduct the amount of interest that would be due on the loan.

Because we have not yet determined how overpayments of the appropriate arm's-length transfer price will be treated under section 482, we suggest that the taxpayer be given the option of treatment of the entire transfer under section 367(d), in which case all income will be U.S. source, or treatment of only the difference between the arm's-length price and the boot under section 367(d). Under the second option, credit for overpayments attributable to [REDACTED]'s share of the CS [REDACTED] would be given, probably without credit for hypothetical interest, and no adjustment would be permitted where the [REDACTED] percent royalty exceeded the arm's-length price determined under section 482. However, to the extent that regulations allowing such adjustments are issued before the statute of limitations for the applicable year has run, the shareholders would be entitled to the benefit of those regulations.

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We recognize that the treatment of this transaction is both complex and unsettled, and we encourage you to contact us further on any aspects that are unclear or that we have failed to address. With respect to questions concerning the determination of an arm's-length price under section 482 or determining the amount of a credit for an overpayment, you may contact Richard Elliott or Ken Wood at FTS 287-4851.

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